

Q. Opinion on Capital Structure and Return on Equity
Kathleen McShane – Volume 3

Pg. 4, #6g - In Canada, has the comparable earnings approach been accepted by regulators as a generally accepted methodology?

- A. Until the mid 1990s, the comparable earnings test was given weight by a number of Canadian regulators. As with other tests for the fair ROE, the comparable earnings test had recognized pros and cons. For example, in E95070 (6/95) for the City of Edmonton, the predecessor to the Alberta Utilities Commission, the Alberta Energy and Utilities Board, while acknowledging that the application of the test entailed some issues, also recognized the relevance of the test in the context of original cost ratemaking, stating:

“In arriving at a rate of return on common equity, the Board considers that, for the purposes of this Decision, all three tests of measuring common equity return are relevant. The Board does not agree with the opinion of the witness for the ERWCG, Mr. Kahal, that the comparable earnings test is of little help or relevance to these hearings because it does not attempt to measure the market cost of equity for the companies in the comparison sample. Rather, the Board considers that there is still some merit in the comparable earnings test to the extent that regulation is considered a surrogate for competition and the comparable earnings test attempts to measure the achieved accounting rates of return on common equity of enterprises of similar risk. The Board does, however, recognize that there may well be distortion in the market to book ratios caused by the effects of inflation on retained earnings of companies, notwithstanding their similarity in risk. Similarly, the comparable earnings test may be sensitive to the selection of the business cycle under study.” (page 43)

The test has not been widely accepted in recent years. The most recent decision in Canada to give some, albeit a small amount of, weight to comparable earnings test, was the British Columbia Utilities Commission’s December 16, 2009 decision, *In The Matter Of Terasen Gas Inc., Terasen Gas (Vancouver Island) Inc., Terasen Gas (Whistler) Inc. And Return On Equity And Capital Structure*. In that the decision, the BCUC stated:

“The Commission Panel has considered the three approaches to determining ROE for a regulated utility and agrees with Terasen that it should take all three into account when establishing an ROE. The Commission Panel agrees that the DCF and ERP are the most common approaches used by regulatory agencies in the US and that CAPM has been widely used in Canada in the period since 1994. The Commission Panel has seen no evidence that suggests: i) it should ignore the fact that the Commission gave the DCF approach weight in the 2006 ROE Decision, or ii) that would persuade it to depart from the Commission’s finding in that decision that the CE methodology had not outlived its usefulness when it commented: “However, the Commission Panel is not convinced that the CE methodology has outlived its usefulness, and believes that it may yet play a role in future ROE hearings.” (pages 44-45)